"Fix It" Episode VIII - Eliminating "Too Big to Fail" & Lessons from the Golden State:

Too Big to Fail: There is a lot of talk these days about the $3 billion loss at JP Morgan Chase. There is a lot of hand-wringing, concern, and investigation into what happened. We are asked about it on Capitol Hill, we have an opinion, and we all care about it. And, that is the problem. We shouldn't have to care.

The only reason we are all in a tizzy over this is because JP Morgan is too big to fail. If Apple announced it lost $3 billion tomorrow, the shareholders, Wall Street and some trial lawyers would care, but it wouldn't be any of Washington's concern. That's the way it should work with private companies. They take risks to make money. Sometimes you win and sometimes you lose.

Dodd-Frank did not fix this problem for the banks. Arguably, a provision in Dodd-Frank was part of the cause of the JP Morgan loss. Dodd-Frank requires disclosure of trading that was previously private. Hedge funds saw JP Morgan taking big positions (which just a few years ago would not have been made public) and decided to play the other side of the trade. The hedge funds won and JP Morgan lost. However, in this case, we all lost. That’s why we have to fix too big to fail. If we do, then JP Morgan's loss becomes just an issue for investors and not for taxpayers.

Over 100 years ago, we enacted anti-trust laws in this country because it was determined that it was not in the public’s interest to have monopolies. I think most people today believe that was good legislation. We need to pass equivalent laws for a financial institution that is "systemically significant" - which is the beltway euphemism for "too big to fail" (TBTF). TBTF entities put the taxpayer at risk for losses without giving the taxpayer any of the gains. TBTF entities have an unfair competitive advantage over other institutions that could, in theory, fail without any government rescue. And because of the implicit government backstop, TBTF entities are encouraged to take more speculative bets than they normally would allow. I think that TBTF institutions should have reserve and capital requirements that make them so safe that they practically could not fail. Of course, this would greatly reduce their return on equity. So, they would have a choice. Be very big and very safe and very boring. Or, break up into smaller units that are individually not too big to fail.

This does not force any company to do anything except cut their ties to the unwritten taxpayer backing one way or the other. Detractors to this idea will point to the international marketplace and say that this will put our large banks at a disadvantage to large banks in foreign countries. I disagree. Banks in Europe are already much larger relative to their economies than US banks. For example, Santander is a troubled Spanish bank much discussed in the news these days. For Bank of America to be as big in the US as Santander is in Spain, Bank of America would need to be 7.5 times BIGGER than it is. And, look at how well that huge bank model is working for Europe right now. Not well.

No, our banks should be competitive because they are strong and our system is stronger, not because they are big.

California: I would be remiss if I did not, as a part of this series, mention the state of my birth and home. I love California. I love the weather and the natural beauty. I love its spirit of enterprise and discovery. I love that it has a culture that rewards and accepts rather than shuns something new and out of the ordinary. But, I HATE California's government. I used to serve in that government and I know it inside and out. California's government is the antithesis of the state itself. There is no enterprise or ingenuity. It is a system that seems bent on perpetuating outdated and failed programs and institutions. And, even as inventive as the California populace is, the government punishes invention and blocks opportunity.

Now, you may ask what does this have to do with our "Fix It" theme for getting the United States on track for a new, extended period of growth and prosperity? Well, California is 12% of the nation's economy. If California is failing, America's growth will be stunted solely because the golden state is so big. And, California is fast becoming the Greece of the United States. Our unemployment rate has hovered around 12% since 2009. That is the 3rd highest in the nation. In the period from 2000-2010, more people moved out of California to the other 49 states than moved in. That is the first time that has occurred since statehood. We have the highest taxes of any state in the nation (recently surpassing New Jersey), but also the largest deficit. We have 12% of the country's population, but nearly 30% of its welfare recipients because we pay out more than any other state. We pay teachers more money than any other state, but have some of the lowest test scores. We pay more than double the cost per year to incarcerate a prisoner as Texas. We now have the lowest credit score for our debt (and just had another warning that it may go lower). And, although I cannot show you a statistic to prove it, I'm sure we have more regulations on everything than any other state. My mother's family moved to California from Kansas in the 1920s not because of the weather, but because of the "freedom" that existed there. If they were alive today, they might move back to Kansas for the same reason.

So, what is Governor Jerry Brown's solution? Not fixing any of this. No reforms to anything. Just raise the highest taxes in the country even higher. He has an initiative on the November ballot to do just that. But, it won't work. Hopefully, the voters will turn this abomination down. But, even if they don't, it won't raise any revenue. Governor Schwarzenegger put through the last tax increase a few years ago and revenues declined after the taxes went up. That's because income taxes are a price on income. When the price of something goes up, people consume less of it. It's simple economics. When the price of milk or gas goes up, people use less. When the price of income goes up, people make less. They change their behavior by taking less risk or by moving their income and business to another state. They seek tax shelters instead of higher earnings. And, that will happen again. I wonder what Texas and Nevada and Florida will do with all the new revenue they get from Californians moving out if Jerry Brown gets his tax increase?

So, this antiquated and ineffective solution will not solve the problem. The Governor will not stand up to the unions (a prerequisite to fix California) or make any real reforms. So, California, like Greece, may soldier on until investors refuse to buy its debt. Then a crisis will occur.

What's the fix? The great residents of this state that gave the world Ronald Reagan will have to demand changes from their elected officials. I just hope they do it before we reach that looming fiscal cliff.